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By email

Kip Meek
Chair of the PR19 redeterminations panel
Competition and Markets Authority

03 February 2021

Dear Kip

Cost of Capital and role of customers in regulatory proceedings

Thank you for the continued hard work of the panel and the CMA team on the four water re-determinations. I welcomed your decision to take additional time to consider the key contentious issues. Your decisions will have a significant impact on customers and investors well beyond the water sector.

I appreciated the opportunity to join the workshop on the WACC on 20 January and this prompted further reflections, particularly on the role of customers in our regulatory proceedings.

I was struck by the weight of academic expertise, focused on arguments of a highly technical nature, which appeared far removed from the 'real world'. The views of companies' key experts in the academic field of corporate finance did not appear reflective of the ongoing investor appetite we see for the sector. Nor were their views reflective of the proposals by non-disputing companies for substantial further investment that I reference below. Leaving our responsibility aside, there was also no representative there with a role to speak for customers.

We are both experienced regulators and used to probing companies' arguments. It is difficult to weigh arguments and avoid becoming anchored in an opinion of the 'right settlement', if one side of the argument repeatedly dominates. Experience of sector regulators is also that the strength of the various sides is not equal. This has likely contributed to the empirical observation, and repeated criticism, that regulators have always erred on the generous side towards companies.

Customer groups have no right of appeal in our process and while there is an opportunity at certain points to be heard, the CMA will appreciate that such groups are much less well-funded and resourced. As the focus of the CMA's exchanges has narrowed to concentrate on highly technical matters, the consumer voice has been drowned out. This is particularly so in the debate about the choices of the parameters underpinning the WACC. The submissions made to the CMA, both formal submissions and letters, have increasingly been dominated by the well-resourced company and investor voice. That voice, unsurprisingly, advocates for a higher WACC.

The other voice that is missing is the observation of what has been happening in the current financial markets of today, and the last five years, with the rise of infrastructure as a highly sought-after asset class. We sought to bring some of that to the hearings in December, but I fear it was again drowned out by the weight of the technical arguments. Our deliberations around the WACC level are not only confirmed by the views of the UK Regulatory Network and other sector regulators, but even now we are seeing non-disputing companies proposing substantial incremental investment programmes for the nation's Green Recovery at the cost of capital levels we allowed in PR19.

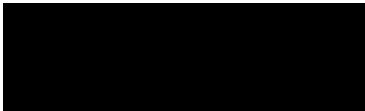
I also ask you to please think carefully about the gearing discussion. There is no doubt that some investors in the sector have over-leveraged their structures. And they have extracted large dividends and withdrawn equity, rather than invested to secure the long-term resilience of a vital public service, their businesses and the environment.

We experience first-hand that, completely regardless of the level of the cost of capital, the structural arrangements of some of the investing funds with their underlying investors, make it difficult to raise appropriate and substantial injections of new equity to recapitalise over-stretched structures. We see this high leverage to be correlated for a good number of companies with poor or declining service and undue constraints on management.

We are not precious about the form of our mechanism to address gearing. If you can improve on it, we'd be really pleased. We also note that removal of the mechanism may be taken by investor interests as CMA approval for equity withdrawals, high gearing and complex structures. Whatever the panel decides, we would be concerned if there was an impression that the CMA is supportive of high gearing or agnostic as to the withdrawal of equity from the sector.

I will not rehearse the arguments that the Ofwat team has already put so well to the Panel in the course of this inquiry. I will only urge you to consider carefully in the final weeks of this redetermination the interest of the customers that cannot be easily heard in these proceedings. It is, after all, customers who will need to foot the bill.

Yours sincerely



Jonson Cox CBE
Chair, Ofwat